DOW THEORY LETTERS INC.

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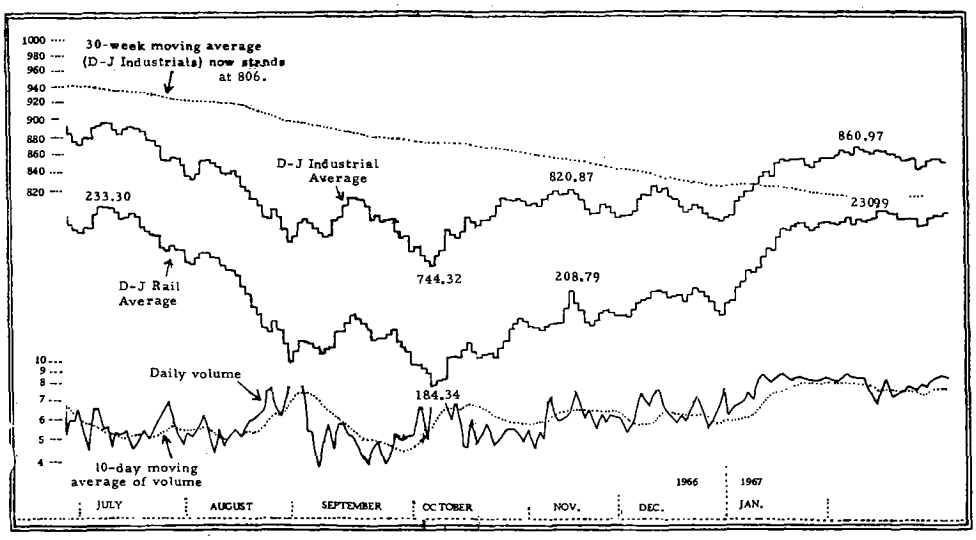
THE MARKET: This writer and this service has espoused the technical approach for over a decade. But it should always be remembered that market analysis is an art, not a science. There is nothing that will "always work" in the market. If this were not so, computers would own Wall Street and most of the nation within a matter of months.

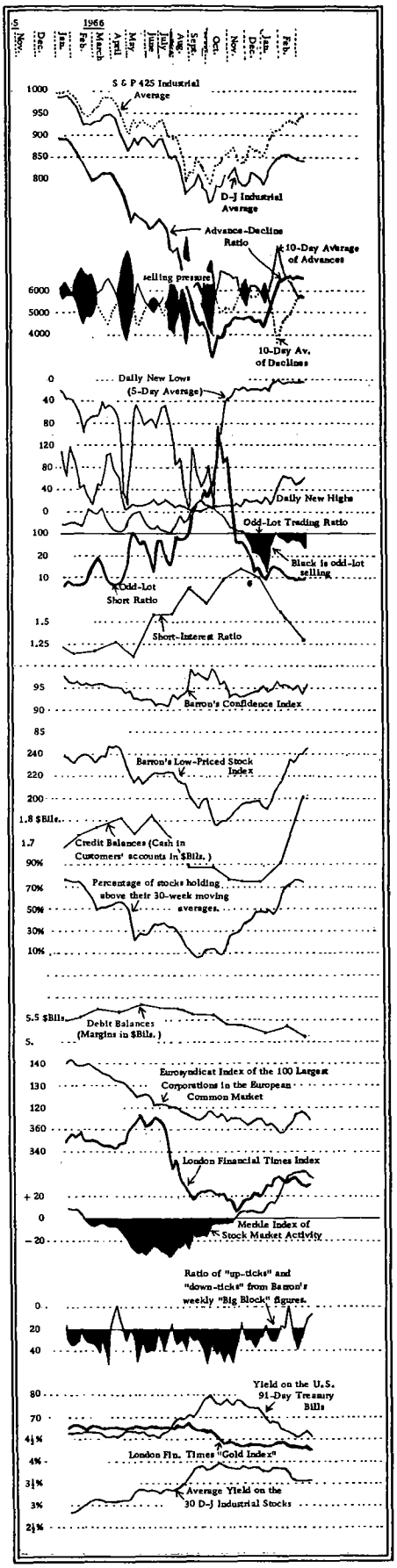
Not a day goes by that I do not receive some sort of an announcement regarding a technical service through the mails. Technical courses are being set up in almost every large and medium-sized city in the country. The public is being led to believe that the technical approach is the way to success and riches in the market. My natural "built-in" skepticism makes me suspicious of this whole line of reasoning at this time. (Note that I say "at this time," since the whole technical orientation could change in a matter of a few years). At the same time, the fundamentals are, in many cases, being completely ignored. But within a primary bear market, at a time when everyone and his brother happens to be embracing the technical approach, I prefer to emphasize the importance of fundamentals. I have been doing this in almost all the Dow Theory Letters of late-1966 and 1967.

As to the market, on February 27, amid a sharp market selloff, the D-J Utility Average broke to a new low for the year. I consider this action bearish, and it is most likely an attempt on the part of informed investors to discount rising interest rates ahead. The action is almost a carbon copy of what occurred a few years ago when the Utility Average topped out (in early-1965) and headed lower throughout 1965 and most of 1966.

In previous Letters I wrote that when the Utility Average and the D-J 40-Bond Average head lower together, it represented a situation which is almost always bearish for the general market. The Utility Average topped on January 19, 1967 at 139.94; the Bond Average peaked at 83.56 on January 30. Since then both of these components have been declining. On February 8 the Industrial Average turned down from its year's high of 860.97, and on February 15 the senior Average was joined by a turndown in the Rails. All of this occurring within the framework of a primary bear trend casts an ominous complexion on the market for the period ahead. I feel that there is a strong possibility that the highs for 1967 have been set by all four Dow components as listed above.

If the Averages have indeed topped out, this is still no guarantee that trouble is "just around the corner." The road down to the lows could be long and labored or it could be fast and furious. No one can predict how the market may choose to decline. I do




1966
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline Ratio
10-Day Average of Advances
selling pressure
10-Day Av. of Declines
Daily New Lows (5-Day Average)
Daily New Highs
Odd-Lot Trading Ratio
Odd-Lot Short Ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Credit Balances (Cash in Customers' accounts in $Bils.)
Percentage of stocks holding above their 30-week moving averages.
Debit Balances (Margins in $Bils.)
Eurosyndicat Index of the 100 Largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
Ratio of "up-ticks" and "down-ticks" from Barron's weekly "Big Block" figures.
Yield on the U.S. 91-Day Treasury Bills
London Fin. Times "Gold Index"
Average Yield on the 30 D-J Industrial Stocks

have a few mental "benchmarks" which I am watching. One is the 830 hourly figure on the Dow. If the Dow touches 830 on an hourly basis then a "sell signal" or reversal will have been registered on my point and figure chart. I would consider this an important bearish omen.

Secondly, there is a discrepancy between the 200-day moving average of the Dow (which now stands at 830) and the 30-week moving average of the Dow (which now stands at 806). In spots like this I prefer to use the actual accurate 200-day reading. The Industrial Average has now held above the 200-day moving average for 6 consecutive weeks (which is par for the course in a strong bear rally). However, I would consider any closing which is decisively under 830 to be bearish in that such a closing would indicate that informed investors were now willing to pay less for the blue-chip Industrial Average than they have been on average over the past 200 days. In other words, I would take a closing of approximately 825 or so to indicate a change in investor sentiment, a change from the bullish "rally psychology" to one of increasing bearishness.

NOTES & QUOTES: The governmental effort to "keep everything going" is assuming an almost frantic look. Unquestionably, the Treasury and the Federal Reserve have not liked what they have observed occurring in the economy. They have rushed in to do battle. A few weeks ago the Treasury went to the rescue of the rapidly tightening money market. They purchased $750 million of government securities. On top of this, the Federal Reserve has stepped up the flow of funds into the marketplace, thereby changing the 14-month negative reserve position of the commercial banks to a plus reserve position. Last week the Fed acted again to increase the credit supply, this time reducing the reserves that member banks must keep idle behind savings and certain other accounts. Meanwhile, back at the ranch the Johnson administration can hardly have been waxing poetic over the outpouring of sour economic news. At word of the action on the monetary front the administration brightened. "We're delighted," said a key administration official. "This is a clear demonstration of the easing the Federal Reserve intends, and I think the market will read it that way."

There is no doubt of the administration's desire to keep shoving "pep pills" into the economy, regardless of the inevitable final consequences. In his latest Bank Credit Analyst bulletin, Mr. A. Hamilton Bolton notes that the greater the period of credit expansion, the greater the subsequent era of credit risk. Hamilton lists three periods of great credit expansion in this century. "Credit expansion was dramatic in the 1924 to 1929 area as it was in the period leading up to 1920. And since 1960, we have witnessed another fantastic growth in credit." Later Bolton concludes, "We may try to draw parallels too closely between what happened in 1920-21, in 1929-32, and what may happen from 1966 on, but we do have the logical (and proved in the two prior periods) suppositions that what creates increasing credit risk in the market place is too rapid increases in private credit over a given prior period. We may not like the message, but it is there to be refuted if one can."

Bolton also draws attention to the incredible current velocity of money turnover in New York. The velocity of turnover started up slowly in the mid-1940's and since 1960 it has been accelerating rapidly. Only once before did the turnover rate (in N.Y.) compare with the current 124 figure. This was in 1929 when for a short time N.Y. turnover of demand deposits approached 160 before collapsing. Bolton takes the current fantastic rate of deposit turnover in N.Y. as the symtom of the ending or near-ending of a great cycle. The velocity of turnover, of course, is not an exact timing device. It is a fever chart which reflects the frenzied (obviously speculative) use of money in New York, the money capital of the world.

* * * *

The following, from the Babson Washington Forecast Letter (Feb. 20), confirms earlier discussions in these Letters: "The 3.2% wage-raise guideline has been eliminated. Prices are creeping upward. Taxes, as a cost to corporations, are substantially higher.....and likely still to climb, at least on a per-unit cost basis. Barring substantial budget cutbacks by Congress, it's an odds-on bet that government spending will necessarily exceed the bare-bone estimates handed down by LBJ.

"On the other side of the coin, there's no real assurance that receipts will reach the levels projected in the budget. The onset of a period of profits squeeze is universally recognized....and lower profits mean smaller dollar revenue for Uncle Sam. It's a safe guess that the projected $8.1 billion deficit is fictional. It could be low by as much as $8.1 billion."

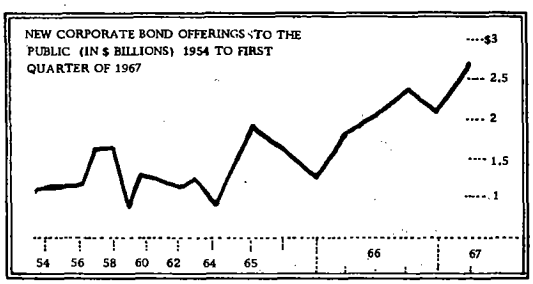
I again want to comment on the speculative type of leadership which has now taken over the market. During true primary bull markets, the quality or Dow-type stocks lead the way up for perhaps two-thirds of the time, and the final or third phase of the bull market is characterized by heavy activity in the speculative issues. But here, only five months from last year's lows, the "junk" stocks have grabbed the spotlight while the quality Dow Average has been unable to regain even 50% of the losses registered during the 1966 decline. This type of action is typical of a bear market rally, and entirely atypical of the kind of action I would expect in a new bull market. Whatever profit squeeze is now working on the giants of American Industry is almost sure to be reflected (in time) in the rest of the secondary and terciary companies of our nation.

THE STORY UNFOLDS: For months I have been giving subscribers my view of things to come. But even the pessimists must have been uneasy as they glanced over last week's financial news. In almost every instance, whether it was general economic news or specific corporate news, the story was worse than expected. And this is as it should be in a primary bear market. Rail equipment makers say that orders for rail equipment have practically stopped. Machine tool orders last month dropped 37% behind the year ago level, and cancellations were three times the 1966 rate. Steel buying for April is lagging contra-seasonally behind the March buying level. Traditionally, the second quarter is the strongest quarter of any year for the steel industry. Auto sales have dropped far under the lowered expectations of even a month ago. If the current rate of auto sales continues, the industry could have a 7 million car year, which would be quite a shock. Furthermore, inventories of autos in April threaten to climb over 1.5 million, a level which would represent a heavy burden on the entire industry.

And against all this lurks the specter of rising interest rates. I have written almost ad nausea regarding the coming U.S. Government deficits, deficits which could mount to $30 or $40 billions if a business recession should arrive, thereby greatly reducing corporate profits (and Government tax receipts). Already we have received intimations of the coming profit-recession in such reports as the GM fourth quarter report (profits off 6% from a year earlier), the Ford fourth quarter report (profits down 21% from a year earlier), the Chrysler report (profits off 32%) and the GE report (profits off 43% from a year earlier). Perhaps the best example of what is happening is shown by the fourth quarter earnings of $14.50 for the Dow Industrials, which is well under the $15.53 of the second quarter (although the fourth quarter is almost always the best quarter of any year).

Thus the economic picture is one of falling corporate earnings; it is only a question of how much they are to fall. Furthermore, as earnings fall corporations are rushing full-tilt into the bond market for new money, and the accompanying chart on page 3 shows this

most dramatically. Corporate bond issues scheduled for March are now an all-time record $2.75 billions. On top of this state and local governments are coming into the bond market for approximately $12.5 billions in 1967, up from $11.3 billions in 1966. Pile a whopping Federal deficit on this, add the unkown of mounting expenses in Vietnam, and you have all the ingredients for a potential mess in the bond markets.



It's literally a case of the snake eating its own tail. As interest rates mount, hope for a revival in the housing industry will ebb, and as housing, appliance and auto sales slide, industry throughout the nation will suffer, thus cutting tax revenue to the Government and boosting the need for even more money on the part of Washington.

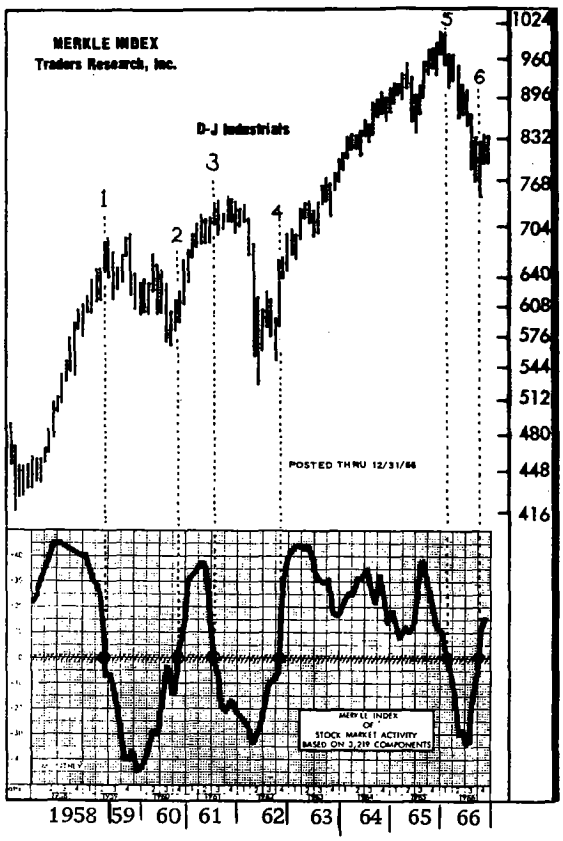
I do not pretend to know how it's all going to work out, but I feel very strongly about this— a primary bear market is underway, and the prognosis is for major trouble ahead. Things seldom work out "the way you want it" in a bear market. A primary bear market has a way of jarring the foundation, shaking everything loose, exposing the rotten wood.

How could all this possibly happen, I am asked? With all the current modern data and economic sophistication, how could our nation's economists be surprised by real trouble ahead? Look through the financial pages (go to your local library) and see how many economists in the last quarter of 1966 expected auto sales to be down 15% to 20% during the first quarter of 1967. If our leading economists can't make accurate predictions regarding one of the nation's largest industries, can they be expected to be any more accurate about the whole trend of the economy during a primary reversal?

MERKLE INDEX: Being right is the best advertisement on Wall Street. Over the past month I have received dozens of requests for more on the Merkle Index which appears in the Composite Chart (page 1) of these reports. My friend Dan Merkle of Traders Research gave me special permission to use this Index a few years ago, and the Merkle Index appeared in Letter 270 (November 5, 1964) and in all subsequent issues of Dow Theory Letters. It is the only "predictive index" of any type which has ever appeared in this publication on a regular basis.

I have included the Merkle Index because I have a great deal of faith in the cold, emotionless analytic power of Dan Merkle. He is a first-rate technician, and as far as I know, he doesn't miss very much that goes on in the stock market (or the bond market, or any other market for that matter).

A few weeks ago I asked Dan to draw me a new chart of the Merkle Index with the Dow superimposed above the Index. I include that chart in this Letter. Note that there have been six "signals" since 1958, a signal being a crossing either above or below zero on the Index. The signals have been followed by market movements of varying intensity from the major rise of 1962-66 to the lesser rise of 1960-61; from the relatively painless drop of 1959-60 to the crushing cave-ins of 1962 and 1966. No signal ever invented in technical analysis will tell you "how big" advance or decline is going to be. It is enough if the signal works reliably in regards to changes in direction. (Note, the chart does not include the computations for 1967, which figures appear on the page 1 Composite Chart).



Should one take every signal on the Merkle Index as a "guarantee" of profits? The answer as I see it is this. I personally would prefer to accept the Merkle signals within the context of my own interpretation of the primary trend. Thus the latest (number 6) signal, in my opinion, came within the context of a primary bear market. It was still a beautiful signal in that it caught the first big upward correction since the February, 1966 bull market top. I am sure that all readers (myself included) will watch the Merkle Index with great interest as we check its predictions of market activity in the months ahead. For the benefit of all subscribers, I include below Dan Merkle's description of the composition and value of the Merkle Index.

"The Merkle Index of stock market activity is a unique indicator developed by the president of Traders Research, Inc., to serve an 'oscillograph.' It is intended to measure the general swings of investor sentiment. It appears to be capable of showing the magnitude and direction of the phases of market cycles.

"The original index was created after four years of applied research and testing. It has been extensively modified and re-worked to reflect the teachings of experience in a wide range of market conditions, from mild to severe.

"The Merkle Index represents much original effort. For this reason the method of constructing it is a closely held secret. However, it is possible to discuss its components in broad terms.

"Four types of market analysis provide the groundwork: evaluation of market barometers (based on a set of flexible mechanical rules); mechanical interpretation of the class of indicators which are shown as moving averages and families of curves; analytical study of all listed stocks, also based on flexible rules; and mechanical interpretation of all listed stocks.

"These methods of analysis are applied to industry groups as well as to individual stocks. Included in our procedure are breadth of market studies, odd lot trading, disparity analysis, volume studies, stock and group trends, bond-stock relationships, and various weekly and monthly statistics. The Index includes no stock market averages.

"Most important is the fact that each component is weighted and adjusted according to a time and accuracy ratio. For example, there are seven components in the odd lot trading section and each is weighted for accuracy and lead or lag time, and adjusted for seasonal changes and 'nature of the market' conditions.

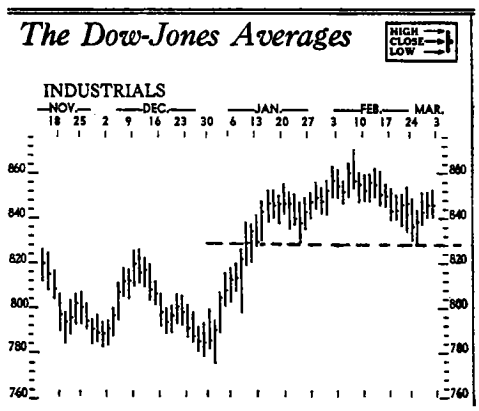
"The Index is based on detailed analysis of 3,047 stock charts, 131 industry groups, and 41 market indicators. The history of the Merkle Index is shown on the accompanying chart (page 3). Note the points at which the Index touched high or low, and the points at which the Index broke above or below the critical zero level.

"The Index oscillates between plus 50 and minus 50. Zero indicates a balance between bullish and bearish. Generally, if half the indicators are bullish and half are bearish, the situation is doubtful, and the investor should have only half of his funds committed.

"As the Index moves into plus territory, additional commitments may be made. As it moves down into minus territory, holdings may be lightened. The degree of involvement at any time is a matter of the investor's judgement and purpose.

"This Index has been a key factor in our investment success for many years. IT IS BETTER TO MOVE IN AND OUT OF THE MARKET GRADUALLY THAN TO SUBJECT ONE'S SELF TO THE RISKS AND EMOTIONAL PROBLEMS OF ALL-IN OR ALL-OUT DECISIONS."

CHART OF THE WEEK: I include this chart of the Industrial Average from the Wall Street Journal mainly because nobody else has mentioned it. It shows the Dow in a potential "head-and-shoulders" top formation with the critical "support line" in the 825 area. I have never been too impressed with "formations" in the Averages, but this one struck me as particularly interesting, coming as it does in the face of optimism from almost every professional market analyst. As I read this chart, a break below 825 could have interesting implications for the market (and I say this bearing in mind that this little head-and-shoulders has appeared within the overall context of a rally in a primary bear market).



LATE THOUGHTS: People ask me "how big" the coming primary bear market is liable to be. I think it is going to be a big one. Newspapers, magazines and sundry publications come to this office on a large scale each week. This wealth of material allows me to see many items which the average person might not have access to. The developing story, as I see it, is big. For instance, on the front page (Mar. 6) of the Christian Science Monitor is a large chart and story about the sudden and sharp decline in farm prices. From the monetary front, Robert Roosa (former Undersecretary of the Treasury) states, "We are in a crucial year because we have just had these deficits for too long. Any reversal...becomes magnified, amplified. Its interpretation abroad is that this is evidence the U.S. is floundering, isn't trying, isn't getting anywhere. That sets off a chain reaction."

From the National Observer comes gloomy words from Europe: "No one is predicting a depression, but practically everyone agrees that the rest of Europe will march to the economic cadence set by Britain and Germany. And those countries—Britain because of its chronic balance-of-payments problem and stiff measures to overcome it, Germany because of waning investment growth and 100,000 employees idled at Volkwagon alone—are footsore indeed." From Business Week (Mar. 4) comes word that U.S. auto "production schedules—still apparently too high despite the latest round of cutbacks both planned and unplanned—may be in for further trimming if sales don't improve soon."

From all quarters the story emerges, and it encompasses the monetary, the durable goods industry, profit margins, international trade agreements, gold, silver, politics and international politics, consumer spending, inventories, everything, the works. The single hope of the bulls is that the market rally is predicting the coming end to troubles and a turn to the better. But I take the current rally to be a correction in a primary bear market. That's the "fly in the ointment."